

of natural gas pipelines and, later, gas local distribution companies ("LDCs"), as competition has been introduced into those markets.

As a matter of competitive policy, it should also be observed that the approach employed by the FERC has proven successful in accomplishing the transition to competition in the natural gas industry. The natural gas pipeline industry presently is substantially unbundled and highly competitive. According to one study, 85% of natural gas was delivered and owned by non-pipelines in 1991, compared to 29% in 1981. That study showed that total deliveries of natural gas increased from 17 trillion cubic feet ("Tcf") in 1986 to 25 Tcf in 1991, gas prices decreased by one-third between 1985 and 1991, while industry productivity increased.^{82/} Competition also is increasing in gas LDC service areas within the states. The provision of stranded cost recovery during the transition to competition in these markets has not kept them from developing rapidly and successfully. To the contrary, it has facilitated the development of economically efficient competition. The FERC also has put into place most of the pieces required for a fully competitive wholesale electricity generation market, which is producing lower costs for many wholesale electricity requirements purchasers.

C. Government Consistency

It also is reasonable, as a matter of law and sound public policy, to expect agencies of the federal government to act in a consistent manner in their treatment of prudent, actual system costs rendered unrecoverable as a result of government-mandated

^{82/} See Mercer Management Consulting, Inc., The Impact of Deregulation: An Overview Across Five Industries (Edison Electric Institute, Feb. 1995).

industry restructuring. As discussed above, there are strong parallels between the telecommunications industry and the natural gas and electric industries as the latter industries have moved from a traditional, monopolistic structure to a more competitive structure. These parallels strongly suggest that the FCC's treatment of embedded cost recovery should be consistent with the FERC's treatment of the stranded and strandable costs of natural gas pipelines and electric utilities. As the FERC learned, the federal courts have not permitted regulatory bodies to ignore costs which were incurred under traditional regulation as the regulators developed their policies for transition to a more competitive market structure.

In addition to the strong legal and policy reasons for cost recovery discussed above, it is reasonable for investors in traditional utilities, whether telephone, gas, or electric, to expect different agencies of their national government to respect their rights in a consistent manner. The inconsistency within the federal government concerning transitional cost recovery is all the more significant when one considers the 1996 Economic Report of the President. That report clearly confirms the concerns that have been expressed and acted upon by the FERC concerning recovery of actual system costs incurred under traditional regulation when recovery is threatened by government-mandated changes, and stresses that "credible government" requires policies that reduce losses for investments made based on earlier rules.^{83/} The FCC's TELRIC pricing methodology and cost recovery "shell game" are inconsistent with the stated policies of the FERC and the White House.

^{83/} Id.

VIII. CONCLUSION

As the preceding discussion indicates, regulators have addressed the issue of cost recovery in the natural gas and electric industries in ways far different from and superior to TELRIC. In doing so, regulators have successfully promoted the introduction of competition in those industries without the potential for market distortion and unconstitutional confiscation posed by TELRIC.

Rather than TELRIC, the FERC's approach to permitting the recovery of potentially stranded costs in the natural gas and electricity industries should be applied to the incumbent LECs. Doing so as soon as possible could save the FCC, state regulators, the U.S. telecommunications industry, and consumers from repeating the FERC's experience with cost recovery before arriving at the same result. As discussed above, as the natural gas industry moved toward competition, the FERC first largely ignored embedded costs incurred by regulated pipelines, but, after lengthy proceedings and repeated judicial remands, ultimately recognized the need for recovery of these costs. Applying this experience to the electric industry, the FERC recognized both the legitimate right of utility investors to recover actual costs "stranded" in the transition to competition and the policy necessity to provide for such recovery in order to achieve a fully competitive marketplace. The FCC should apply this experience to the actual costs of the incumbent LECs, as well.

It would be irrational from both a policy and an administrative perspective for the FCC or state regulators to impose costing approaches on incumbent LECs that differ so markedly from those applied by FERC and the states to incumbent electric and natural gas utilities facing a similarly new competitive environment. The Clinton Administration's recognition of the efficiency and equity reasons for permitting recovery of embedded costs

demonstrates that the FCC's TELRIC approach is inconsistent with White House policy, as well.

State regulators should take advantage of their authority over cost recovery under the Telecommunications Act to recover the actual costs associated with network elements and interconnection in a sound manner. Specifically, permitting LECs to set rates for network elements and interconnection arrangements to recover actual costs, while providing increasing flexibility to align other prices more closely with costs, will enable those LECs to recover those costs in an efficient manner.^{84/}

Moreover, regulators should permit incumbent LECs to use market-driven depreciation rates, at the wholesale and retail levels, to permit more rapid recovery of embedded costs and the depreciation reserve deficiency.^{85/} As discussed above, state regulators are using such mechanisms in recovering the costs of nuclear power plants. In the Access Reform Notice, the FCC recognized that underdepreciation of incumbent LEC assets may be a possible regulatory cause of some of the difference between interstate-allocated embedded or accounting costs and forward-looking costs.^{86/} As that notice observes, underdepreciation can occur if either (i) the useful lives prescribed for regulated facilities

^{84/} As the FCC has recognized, however, to the extent that current separations rules over-allocate costs to the interstate jurisdiction, such flexibility alone may not give incumbent price cap LECs a reasonable opportunity to recover their costs fully, particularly if such flexibility is phased in gradually. See Access Reform Notice at para. 261.

^{85/} Jeffrey Rohlfs, Charles Jackson, and Ross Richardson have demonstrated that there is a large "depreciation shortfall" for incumbent LECs that regulators urgently need to address. See Jeffrey H. Rohlfs, Charles L. Jackson, and Ross M. Richardson, The Depreciation Shortfall, Attachment 15 to Comments of the United States Telephone Association to the Federal Communications Commission, CC Docket No. 96-262 (filed Jan. 29, 1997).

^{86/} See Access Reform Notice at para. 250.

exceed the economic lives of those facilities,^{87/} or (ii) depreciation procedures do not recognize the decline in the economic value of plant already in service that occurs when the replacement cost is less than the cost of the older equipment.^{88/} In the second case, which we believe exists in the competitive marketplace emerging under the 1996 Act (along with the first case, as well) incumbent LECs' deployed equipment will be under-depreciated by an amount equal to the difference between the current net book value and the forward-looking replacement cost of the depreciable plant.^{89/} By adjusting depreciation rates based on market conditions, while allowing cost recovery in rates, LEC cost recovery will more readily be aligned with actual costs, including embedded costs.

If such sound cost recovery methods are not followed, few alternatives to confiscation exist, and those would have negative public policy consequences. For example, there could be pressure for haphazard local rate increases to cover these regulation-driven costs of serving competitors not otherwise recoverable under the TELRIC methodology. Of course, some local rate rebalancing could be desirable to align rates more closely with underlying costs. However, having to raise local rates an additional amount to make up for shortfalls in a narrow incremental pricing methodology like the FCC's version of TELRIC is undesirable and should be avoided.

Regulators have established a history of accomplishing transitions to competition through carefully crafted processes that include providing for the recovery of embedded costs that utilities have incurred under their obligation to serve the public. This

^{87/} See *id.* at para. 251.

^{88/} See *id.* at para. 253.

^{89/} See *id.*

history should not be ignored by the FCC or state regulators in implementing the Telecommunication Act of 1996.

IX. ABOUT THE AUTHORS

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William D. Steinmeier is an attorney and regulatory consultant whose practice focuses on utility regulatory policy issues, with particular emphasis on electric industry market and regulatory structures, incentive (performance-based) ratemaking, accelerated nuclear depreciation, and other stranded cost recovery methods. He has co-authored three papers on stranded cost issues on behalf of the Edison Electric Institute. He also serves as National Chairman of the Electric Utility Shareholders Alliance ("Electric USA"), an ad hoc political initiative designed to give a voice to shareholder and small consumer concerns in the Congressional debate about federally-mandated retail wheeling of electricity.

Mr. Steinmeier served as Chairman of the Missouri Public Service Commission from 1984 to 1992. He is also a former President of the National Association of Regulatory Utility Commissioners (NARUC).

Mr. Steinmeier has consulted on the restructuring and privatization of electric systems in several former Soviet Republic, including Kazakstan and Kyrgyzstan, and in Ghana in West Africa. His work contributed to the new electricity law adopted by the Republic of Kazakstan in December, 1995.

Mr. Steinmeier earned his B.A. degree in political science in 1972 from Wheaton College in Illinois and his J.D. from the School of Law of the University of Missouri-Columbia in 1975. He is a member of the Missouri Bar.

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James M. Fischer is an attorney in private law and regulatory consulting practice. Prior to entering private law practice in January, 1990, Mr. Fischer served for six years as a Commissioner and Vice-Chairman of the Missouri Public Service Commission. He served on the National Association of Regulatory Utility Commissioners (NARUC) Communications Committee, serving as its Litigation Task Force chairman. He was a member of the Federal-State Joint Boards in CC Docket Nos. 80-286 and 85-124, dealing with numerous separations issues, as well as the FCC's Joint Conference on Open Network Architecture. He also served as a member of NARUC's Task Force on Cable Television/Telco Cross-Ownership.

Mr. Fischer also represented the states and NARUC in oral arguments before Judge Greene concerning the line of business restrictions on the Regional Bell Operating Companies during the first triennial review of the AT&T Modified Final Judgment.

Prior to his appointment to the Missouri Public Service Commission, Mr. Fischer served as the Public Counsel for the State of Missouri from 1981 to 1984. From 1976 to 1981, he was an Assistant Public Counsel in that office.

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Albert Halprin is an attorney with the law firm of Halprin, Temple, Goodman & Sugrue in Washington, D.C. Prior to this, from 1984 through 1987, he was Chief of the Common Carrier Bureau of the Federal Communications Commission (FCC). Before serving in that capacity, he served as Chief of the Policy and Program Planning Division of the FCC's Common Carrier Bureau and as a Senior Attorney-Advisor in that division.

While he was at the FCC, Mr. Halprin was one of the principal staff members responsible for developing the recommendations to the Commission which led to the establishment of the access charge rules. He also served as the Chief of the Common Carrier Bureau during the implementation of the access charge plan.

During his service at the FCC, Mr. Halprin was very involved in matters impacting the jurisdictional separations process and the settlements process, and worked closely with the Federal-State Joint Board that was reviewing the issues related to access charges.

Mr. Halprin serves as an adjunct professor of telecommunications law at Georgetown University Law Center. He is a 1974 graduate of The Harvard Law School and a 1971 graduate of Western Washington State College.

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